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No. 85-668

In the Supreme Court of the United States

OCTOBER TERM, 1985

WARREN G. WHEELER, JR., ET UX., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether amounts paid to college-age children by an educational benefits plan funded by their parents' employer are includible in the parents' gross income as compensation for services, where the plan is designed as an incentive to continued employment and is limited to key employees selected by the board of directors.

2. Whether the inclusion of such amounts in the parents' income denies them equal protection of the laws, where the tax laws exclude from gross income, as "scholarships," certain tuition remission benefits provided by educational institutions to the children of college faculty members.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A25) is reported at 768 F.2d 1333. The oral opinion of the Claims Court (Pet. App. A168-A188) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on July 25, 1985 (Pet. App. A26). The petition for a

writ of certiorari was filed on October 21, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioners Warren G. Wheeler, Jr., and James J. McLaughlin, Jr.,[1] were employed by the South Bend Tribune Corporation (South Bend) during 1975 and 1976 (Pet. App. A6-A7). In 1975, South Bend entered into an educational benefits plan agreement with Educo, Inc., under which South Bend provided funds for the college expenses of the children of certain of its key employees (*id.* at A7, A199-A214). South Bend made sufficient contributions to the plan to provide funds for the payment of $2,000 per year to each eligible child, with a maximum total payment of $8,000 per child. Payments were made from the trust fund directly to the child or to the child's creditors. The employee-parent had no right to receive any of the money in the trust or to control its disposition (*id.* at A7-A8). If an employee left South Bend, his children would no longer be entitled to benefits under the plan (*id.* at A8, A208).

South Bend adopted the plan as an employment incentive to obtain and retain key employees (Pet. App. A7-A8, A200). South Bend's board of directors selected the employees whose children would be eligible for the benefits. South Bend in 1975 designated only 16 high-level employees (out of its 800 or 900 employees) for participation in the plan (*id.* at A8).

During 1975 and 1976, the trustee of the plan paid $2,000 toward the college expenses of the Wheeler's son

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[1] Petitioners' wives are parties solely by virtue of having filed joint income tax returns with their husbands for the years in issue.

and the McLaughlins' daughter. The Commissioner determined that these amounts were includible in petitioners' respective gross incomes. Petitioners paid the resulting deficiencies in tax and, following the denial of their administrative claims for refund, brought these refund suits, which were consolidated for trial in the Claims Court (Pet. App. A8-A9).

Ruling from the bench, the Claims Court (Kozinski, C.J.) followed the Seventh Circuit's decision in *Armantrout* v. *Commissioner*, 570 F.2d 210 (1978), which involved an almost identical Educo plan, and held that South Bend's payments to the children represented compensation to their fathers, and thus constituted income to the latter in the years in which the payments were made (Pet. App. A168-A183). The court noted that the payments provided a concrete economic benefit to the parent-employees, since those payments effectively reduced the parents' college-tuition bills by $2,000 annually (*id.* at A173, A177). The court concluded that, as a practical matter, a child's participation in the plan resulted from the implicit bargaining inherent in the employer-employee relationship, *i.e.*, that the payments were simply one component of the "economic package of benefits" provided by South Bend as compensation to Wheeler and McLaughlin (*id.* at A176-A177). The court accordingly held that the payments were "like salary" and were "additional compensation" properly includible in petitioners' income when paid by the plan to their children (*id.* at A182).

The court of appeals unanimously affirmed (Pet. App. A1-A25). It concluded that the payments received by petitioners' children under the Educo plan were "compensation for the services their fathers rendered to South Bend" (*id.* at A11). The court

observed that the payments conferred an economic benefit upon petitioners by providing financial support for their children's education, support that the parents themselves would otherwise have furnished (*ibid.*). The court found it irrelevant that South Bend did not bargain directly with its employees about the Educo plan, pointing out that benefits received under the plan "obviously were factors the company took into account in determining compensation" (*id.* at A13). The court also found it immaterial that the payments were made to the children and not to the employees themselves, relying on the fundamental principle that income must be taxed to the person who earns it—here, the children's fathers (*id.* at A14-A15).

The court of appeals also rejected petitioners' argument that inclusion of the payments in their respective gross incomes violated the equal protection component of the Fifth Amendment, an argument based on the fact that certain tuition remission benefits provided by educational institutions to the children of college faculty members are exempt from taxation as "scholarships" (Pet. App. A15-A25, citing Treas. Reg. § 1.117-3(a)). The court noted that Congress may provide tax benefits to a particular class of taxpayers, while denying similar benefits to a different class of taxpayers, if the classification bears a rational relationship to a legitimate governmental purpose (Pet. App. A17-A21). The court found several rational bases for the classification at issue here and accordingly rejected petitioners' equal protection claim (*id.* at A22-A25).

ARGUMENT

The decision below is correct. Contrary to petitioners' assertion, that decision is consistent with the decisions of every other court of appeals that has considered the question. There is no conflict with any decision of this Court and no other basis for further review.

1. Section 61(a)(1) of the Internal Revenue Code [2] defines "gross income" to include "compensation for services." This definition "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945). The courts below correctly concluded that the payments to petitioners' children represented compensation for their fathers' services, since those payments were part and parcel of the compensation package that South Bend offered in exchange for its employees' labor. As the court of appeals observed (Pet. App. A13), South Bend treated the benefits paid through the plan as compensation to its employees; it adopted the plan as an incentive to encourage key employees to stay with the company, and it used the plan as a means of recruiting new high-level employees (*id.* at A7-A8, A13). From the parent-employee's perspective, payment of part of his child's college costs was obviously a valuable reward for services rendered. Since the payments conferred an ecoonmic benefit on petitioners in exchange for services rendered, those payments are includible in petitioners' gross income under Section 61(a)(1). The court of appeals' decision to that effect

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[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the period at issue (the Code or I.R.C.).

is in accord with the decision of every other court of appeals that has considered the taxability to a parent-employee of payments made to children under educational benefits plans similar to that here. *Saunders* v. *Commissioner*, 720 F.2d 871 (5th Cir. 1983); *Armantrout* v. *Commissioner*, 570 F.2d 210 (7th Cir. 1978), aff'g 67 T.C. 996 (1977). Accord, *e.g.*, *Grant-Jacoby, Inc.* v. *Commissioner*, 73 T.C. 700, 706-710 (1980).[3]

Petitioners' primary contention (Pet. 6-9) is that they cannot be taxed on the payments in question because the money went directly to their children rather than indirectly to their children through them.

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[3] Petitioners appear to contend (Pet. 9-10) that they received no "economic benefit" cognizable for federal tax purposes because they had no legal obligation to pay for their children's college education. The court of appeals correctly concluded (Pet. App. A11) that the absence of such an obligation is immaterial. As this Court has repeatedly held, gross income for federal tax purposes includes "*any* economic or financial benefit conferred on the employee as compensation" (*Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945) (emphasis added)); an around-the-world-cruise provided free to an employee's family by his employer is an "economic benefit" even though the recipients are not legally required to travel. It is of course true, as petitioners note (Pet. 9-10), that an employer *does* confer an economic benefit on his employees when he *does* discharge their legal obligations. *E.g.*, *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929) (employer's discharge of employee's income tax liability represents taxable income to the latter). But to deduce from that premise that an employer *does not* confer an economic benefit on his employees when he subsidizes their discretionary payments is to commit an error of logic. Petitioners' citation (Pet. 10) of *Commissioner* v. *Hansen*, 360 U.S. 446 (1959), is even more misplaced; that case involved the accrual method of tax accounting and had nothing to do with the taxation of compensation for services.

But this contention, as the court of appeals correctly observed (Pet. App. A14-A15), runs afoul of what this Court has described as " 'the first principle of income taxation: that income must be taxed to him who earns it.' " *United States* v. *Basye*, 410 U.S. 441, 449 (1973) (quoting *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-740 (1949)). See *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930). Under the assignment-of-income principle, a taxpayer "who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle." *United States* v. *Basye*, 410 U.S. at 450. The fact that South Bend's plan was structured so that petitioners themselves had no "right" to the money (see Pet. 6-9), moreover, is irrelevant. "The [person] earning the income * * * cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person," and the government in such a case "need not prove that the taxpayer had complete and unrestricted power to designate the manner and form in which his income is received." *United States* v. *Basye*, 410 U.S. at 449, 452.

Here, it is obvious that Wheeler and McLaughlin earned the income; it was they, not their children, who worked for South Bend. If South Bend had made the payments directly to the fathers as reimbursement for the college expenses they had incurred, the payments would plainly have been includible in the fathers' gross income, and "[t]he result should be no different because the company instead routed the payments * * * to the children" (Pet. App. A41). The court of appeals here, like the other courts of appeals that have considered this question (*Saunders* v. *Commissioner*, 720 F.2d at 873; *Armantrout* v. *Commissioner*, 570 F.2d at 212-213), properly relied on the

assignment-of-income principle in holding petitioners taxable on those payments.[4]

2. Petitioners' contention (Pet. 11-12) that the court of appeals applied an improper standard in rejecting their equal protection argument is frivolous. In *Regan* v. *Taxation With Representation*, 461 U.S. 540, 547 (1983), this Court reiterated the settled principle that "statutory classifications are valid if they bear a rational relationship to a legitimate govern-

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[4] There is no merit to petitioners' assertion (Pet. 7-8) that the decision below conflicts with this Court's decision in *Commissioner* v. *First Security Bank*, 405 U.S. 394 (1972). That case involved Section 482 of the Code, which provides that, "[i]n any case of two or more [entities] owned or controlled directly or indirectly by the same interests, the [Commissioner] may * * * allocate gross income [and] deductions between or among such [entities], if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income." The Court held in *First Security Bank* that the Commissioner could not use Section 482 to allocate insurance commission income to one of a controlled group of corporations, where the corporation in question was prevented by federal law from receiving such commissions. However, as the Court subsequently stated in *United States* v. *Basye*, *supra*, the assignment-of-income doctrine had no application in *First Security Bank*, since "that case involved a deflection of income imposed by law, not an assignment arrived at by consensual agreement of two parties acting at arm's length" (410 U.S. at 453 n.13 (distinguishing 405 U.S. at 403-404)). The instant case, like *Basye* and unlike *First Security Bank*, involves an arm's-length employment relationship, not a deflection of income imposed by law. Petitioners' assertion (Pet. 8-9) that the decision below conflicts with *Bank of Coushatta* v. *United States*, 650 F.2d 75 (5th Cir. 1981), and with *Salyersville National Bank* v. *United States*, 613 F.2d 650 (6th Cir. 1960), is likewise without merit, since both of those cases involved the application to insurance commission income of the principles of *First Security Bank*.

mental purpose. * * * Legislatures have especially broad latitude in creating classifications and distinctions in tax statutes." As the court of appeals correctly held here, there are several rational bases for treating an educational institution's remission of tuition charges for faculty members' children, which under certain circumstances may constitute a tax-exempt "scholarship" (I.R.C. § 117(a); Treas. Reg. § 1.117-3(a)),[5] differently from an employer's direct cash payments to an employee's child. First, as the court observed, a tuition remission is a noncash benefit, and the "administrative difficulty in valuing such noncash benefits may be substantial" (Pet. App. A22). Second, the court properly noted that a tuition remission program is typically available to a broad category of employees, whereas the benefits in issue here were provided to a small number of South Bend's key employees, selected by the company's board of directors (*id.* at A23). Congress may rationally have decided to limit the "scholarship" exclusion to broad-based noncash programs that involve less risk of tax avoidance than do direct cash payments to children of selected high-level employees (see *id.* at A24). Fi-

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[5] As the court below observed (Pet. App. A19), this provision in the Regulation was taken directly from language in the Committee Reports on the 1954 Code, which indicated that Congress intended the term "scholarship" to include such tuition remissions. H.R. Rep. 1337, 83d Cong., 2d Sess. A347 (1954); S. Rep. 1622, 83d Cong., 2d Sess. 188 (1954). In 1984, Congress codified and broadened the Regulation by providing an exclusion from gross income for any reduction in tuition provided to an employee of an educational institution for the education of the employee or the employee's spouse or dependent children. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 532, 98 Stat. 887 (adding I.R.C. § 117(d)).

nally, the court of appeals noted that "Congress could have reasonably decided to exempt tuition remissions for children of college faculty members as a way of promoting higher education by encouraging qualified people to enter and to remain in the academic teaching profession despite low earnings" (*ibid.*). Petitioners make no attempt to challenge the conclusion that the favorable treatment of tuition remission benefits bears a rational relationship to a legitimate governmental purpose, and there is accordingly no basis for further review of petitioners' equal protection claim.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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